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**BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001**

POSTAL RATE AND FEE CHANGES, 2000

Docket No. R2000-1

**INITIAL BRIEF OF RECORDING INDUSTRY
ASSOCIATION OF AMERICA, INC.**

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Dated: September 13, 2000

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This proceeding raises two issues of particular and fundamental importance to members of the Recording Industry Association of America, Inc. ("RIAA"). RIAA members use both the Standard (A) Regular and the Special Standard (B) subclasses to deliver audio and video materials -- compact discs, tapes and digital video discs -- to audio and video club members and other consumers that order these products. The first issue arises because the Postal Service has proposed to increase the "residual shape surcharge" of the Standard (A) rate schedules by 180%. The second arises because the Postal Service has, by its own admission, charged the Special Standard (B) category with costs of pieces that were actually sent at Standard (A) Regular rates. It has, as a result, very substantially overstated the attributable cost of Special Standard (B) in FY1999.

RIAA's position with respect to these issues, each of which profoundly affects the rates that RIAA members pay, may be succinctly summarized as follows:

1. The Commission should recommend a residual shape surcharge discount for the Standard (A) Regular commercial subclass that does not exceed 13 cents before application of the proposed pre-barcode discount. The Postal Service has failed to justify its continued adherence to a single, one-size fits-all surcharge applicable to all four Standard (A) Regular subclasses. The Postal Service has also improperly and unfairly ignored revenue effects in its calculation of the surcharge applicable to the Standard (A) Regular commercial subclass. The Postal Service has further under-estimated revenues that are, in fact, being derived from the residual shape surcharge and it has admitted that its costing methodology treats pieces that qualify as flats as if they were parcels and is, therefore, unreliable. Given the analytic and factual defects in the Postal Service's presentation, a 13-cent surcharge (before application of the barcode discount) will not cause cost burdens to be shifted to other users of the Standard (A) Regular commercial rate category.

2. There is agreement that the Postal Service's original estimate of Special Standard (B) attributable costs for FY1999 is infirm. The Postal Service's explanation of what caused these anomalies is unconvincing as is its proposed remedy. RIAA's approach to adjusting the Postal Service's original estimate of FY1999 Special Standard (B) costs should be adopted and those costs should be reduced accordingly.

I. There is Neither Theoretic nor Factual Justification for a 180% Increase in the Residual Shape Surcharge Paid by Standard (A) Regular Mailers

The residual shape surcharge was implemented on January 10, 1999 as the result of the decision in Docket R97-1. Although not explicitly stated, the Postal Service's proposed residual shape surcharge seems to rest upon the belief that the methodology it employed in R97-1 was unqualifiedly endorsed by the Commission and that the 180% it has proposed in the surcharge is self-justified.¹ This view profoundly misreads the Rate Commission's analysis of the residual shape surcharge in Docket R97-1. It results in a very substantial overstatement of the surcharge the Postal Service has proposed for Standard (A) Regular commercial mail subclass.

A. The Proposal to Maintain a Single Surcharge Across All Standard (A) Subclasses is Indefensible

Although in R97-1 the Commission recommended a "single surcharge" applicable to all residual shaped pieces regardless of the Standard (A) subclass in which they might be entered, it recognized that this was "only a beginning step." *Decision in Docket R97-1* at 427 at ¶5488. The decision explicitly "recognizes that the single surcharge does not reflect the variation in . . . cost differential between flats and parcels by subclass." *Id.* The Commission, therefore, urged the Postal Service to explore this issue further with particular consideration to the question of "how to set shape differentials within the

¹ The Postal Service's proposed barcode discount should be adopted. But, as we discuss in this brief, the surcharge and barcode issues must be considered separately.

Standard (A) subclasses." *Id.* at ¶5489. The Postal Service simply has not done so. The only explanation for the Postal Service's continued adherence to a single or uniform surcharge is "that's the way the current surcharge is formulated." Tr. 10/4107. This explains nothing: It very profoundly misreads the "precedent" (*Id.*) upon which the witness purported to rely.

There simply is no factual basis in this record to justify the imposition of a single, one-size fits-all shape surcharge. The Commission's decision to tolerate a uniform surcharge in Docket R97-1 plainly rested on the premise that, under then current rates, no parcels in any of the subclasses covered their attributable cost. But the surcharge is now in effect. Mr. Moeller admitted that he did not calculate whether and if so to what extent there is now a "negative contribution" for each or any subclass and he did not "have any specific figures" (Tr. 10/4105) on that subject. What we do know, and what witness Moeller did not dispute, is that even under the truncated and peculiar costing methodology employed by the Postal Service, it is clear that the cost differential between flats and parcels differs markedly from subclass to subclass. USPS-T-27 at Attachment F, Tables 6.1 and 6.2. For example, the Postal Service's own testimony shows that the cost differential between ECR parcels and ECR flats is 12-cents per piece greater than it is in the Standard (A) Regular commercial subclass.

It is simply impossible to defend this one-size fits-all surcharge. The application of the same surcharge across four subclasses each of which displays significant differences in cost differentials is, on its face, arbitrary and capricious. The fact that the Postal Service proposes to require mailers of residual shape

pieces to bear only a portion of the measured cost differential does not alter this. If the proposed 27.5% pass through (USPS-T-35 at 7) were applied to the actual cost differentials between parcels and flats by subclass, the surcharge (before pre-barcode discount) for Standard (A) Regular would be 15 cents and the surcharge for commercial ECR would be 18 cents. USPS-T-27 at Attachment F, Table 6.1. In short, the 18-cent surcharge proposed for the Standard (A) Regular commercial subclass not only conflicts with the Commission "precedent" on which it purports to be based, but cannot be reconciled with the fairness and equity criteria of Section 3622(b)(1).

B. The Theoretic and Factual Predicates for Considering Revenue Effects in the Development of a Surcharge for Standard (A) Regular are Compelling

In the R97-1 case, RIAA, among others, pointed out that the surcharge is paid by residual shape piece shippers over and above the rates of the Standard (A) subclass in which the piece is otherwise entered. Because, on average, parcels are heavier than flats within the same subclass, surchargeable pieces pay more, under the piece-pound rate structure, than the comparable flat of the same subclass. We argued that the revenues the Postal Service receives from shipments subject to the parcel shape surcharge should be included in determining the amount of the surcharge. The Commission rejected this analysis in the R97-1 case but did so on very narrow grounds: The Commission concluded that, although it "cannot permanently rule out the use of revenues . . . there is not a sufficient theoretic basis justifying its use . . . in the instant case."

Decision in Docket R97-1 at 426, ¶5485. Accordingly, and again recognizing that the R97-1 decision was only a "beginning step" the Commission specifically directed the Postal Service to attend, in future filings, to "both the similarities and differences between worksharing and shaped-based differentials." *Id.* at 427, ¶5489. The Postal Service has defaulted on this issue as well. RIAA has not.

Witness Glick, on behalf of RIAA, demonstrates that there is a compelling "theoretic basis" for consideration of the revenue effects in the development of a surcharge for the Standard (A) Regular commercial subclass. He shows that the failure to do so improperly imposes revenue burdens on mailers who use the Standard (A) Regular commercial subclass to ship residual shape pieces. It is certainly true that in the development of worksharing discounts, the only relevant consideration is the costs that the Postal Service actual saves as the result of worksharing activities performed by the mailer. However, in the development of "shape-based differentials" the purpose of the inquiry is very different: the goal is to isolate a particular cost-causing characteristic from among other cost-causative differences between two different subsets of mail. Thus, as Mr. Glick testifies, the analogy to worksharing cost savings measurement "is inapposite":

The more appropriate analogy is to the methods used by the Commission to reflect cost (and rate) differences resulting from shape, among the other cost-causing characteristics, of different recognizable types of mail pieces. . . . One must control for cost differences caused by *all characteristics other than shape*.

Tr. 23/10392 (emphasis supplied). In measuring the cost difference between Standard (A) flats and parcels "the cost characteristics that must be held equal include the depth of presort and depth of drop ship as well as weight." Tr. 23/10392. Witness Crum did include corrections "to account for differences in cost characteristics." He did not make any adjustments for the differences in weight. Tr. 23/10392.

Ideally, isolation of shape as a cost driver in the Standard (A) subclass would be accomplished by analyzing reliable cost data by shape and weight increment. Since the Postal Service has no such studies, Mr. Glick explains that the proper approach for "correcting the non-letter cost difference for differences in weight is to use the weight-related revenue difference between flats and parcels as a proxy for the weight-related cost difference." Tr. 23/10393.

Finally, witness Glick explains why his inclusion of weight-related revenue effects is entirely consistent with the shape-based differential that the Commission has traditionally employed in the development of the letter-flat differential but yields a very different result: In the case of the letter-flat differential, it is not necessary to isolate for weight-related costs or revenues because the comparison involves mail of "approximately the same weight." Tr. 23/10393. However,

The average Standard (A) commercial parcel weighs 2.5 times as much as the average Standard (A) commercial flat having a pound rate as well as including weight-related cost differences in setting the residual shape surcharge amounts to double-charging parcels for weight-related costs.

Tr. 23/10393. In sum, the inclusion of revenue effects (as a proxy for weight-related cost differences) does not really depart from the Commission's "traditional procedure for setting shape-based rate differentials." *Decision in R97-1* at 426, ¶5485. It simply applies that methodology in a context in which weight as well as shape, are cost-causative factors and in which the failure to reflect weight-related differences distorts the cost differentials being measured.

The Postal Service offers no cogent rebuttal to Mr. Glick's analysis. Witness Moeller's asserts that the Commission need not trouble itself with the revenue cost relationship because the Postal Service has proposed a 3-cent discount for machinable pre-barcoded parcels. USPS-T-35 at 7-8. This entirely lacks explanatory force because some mailers will pay 18 cents and because the discount is based on avoided costs, not shape-related cost drivers; the notion that the barcode discount should be viewed as an offset to the surcharge serves only to perpetuate the confusion between the measurement of worksharing cost savings and the measurement of cost differentials resulting from differences in cost-causative characteristics.

The further argument that it would "not be undesirable for Standard (A) parcels to make some contribution to institutional costs" (USPS T-35 at 7-8) equally misses the mark. As indicated, witness Moeller made no attempt to determine whether, at current rates, Standard (A) Regular commercial parcels make a negative contribution. Thus, there is no sound support for his conclusion that, at 18 cents, any contribution made would only be slight. In fact, there is simply no means of determining how much of a contribution parcels in the

Standard (A) commercial subclass make now, much less how much of a surcharge would be needed to achieve "similar" coverages for Standard (A) parcels and flats. Tr. 10/3935. Mr. Moeller based his conclusions on FY1998 cost and revenue figures. These are meaningless in view of the implementation of the surcharge in January 1999, and the other changes in rates and costs that occurred in FY1999.² He has also entirely ignored the differences in weight-related costs which Mr. Glick calculated to be 20 cents at current rates. Indeed, Mr. Moeller himself conceded that it is "theoretically possible" that Standard (A) Regular commercial make a "higher contribution" than do flats in that subclass. Tr. 10/3935.

In R97-1, the Commission carefully explained that it recommended the surcharge to address what was perceived to be intra-class cross subsidies. *Decision in R97-1* at 426. It never said that the purpose of the surcharge was to equalize the contributions of parcels and flats and there is neither statutory nor economic grounds for this result. By ignoring weight-related cost differences, however, the Postal Service overstates the extent of the cross-subsidy at current rates, if there is one. The Commission should not perpetuate this distortion of the purpose of the surcharge. In calculating the appropriate surcharge for the Standard (A) Regular commercial subclass, the weight-related revenue difference between parcels and flats must be taken into account.

² Mr. Moeller speculates that the FY1999 cost differential between Standard (A) Regular commercial parcels and flats might be greater than it was in FY1998 because less costly parcels might have been properly entered as flats. Tr. 46-D/21494. This conjecture fails on two grounds: it ignores the fact that these pieces were treated as parcels for costing purposes (see discussion *infra* at Part C.2); and it also ignores the fact that any cost increase in parcel costs may have been weight, not shape, related.

C. The Postal Service's Under-Estimation of Revenues and Mismatch of Costs Reinforce the Conclusion that the Residual Shape Surcharge Applicable to Standard (A) Regular Commercial Subclass Must be Significantly Less Than the 18-Cent Rate Proposed by the Postal Service

1. The Postal Service has Under-Estimated Surcharge Revenues

Under the DMCS language proposed the Postal Service and recommended by the Commission in the last case, Standard (A) subclass mail is subject to the surcharge if it is either "prepared as a parcel" or, alternatively, if it is "not letter or flat-shaped." DMCS 321.25. In its implementation, the Postal Service recognized that certain pieces -- those between .75 and 1.25 inches thick (Tr. 10/4049) -- are "flat-shaped" and are not always "prepared as a parcel." It concluded, quite correctly, that by the terms of the DMCS provision, these pieces are not surchargeable. In this case, and equally correct, witness Moeller realized that some adjustment to his surcharge revenue estimate would have to be made to reflect these non-surchargeable parcels. Having absolutely no data as to the number of parcels that were not surchargeable in the Base Year -- which predated implementation of the surcharge -- Mr. Moeller simply made a judgmental estimate of revenue reduction by arguing that 25% of the "ostensibly parcels" would meet the dimensions of and otherwise be prepared as flats. USPS-T-35, WP 1 at 14. Tr. 10/4070. He carried forward this judgmental reduction of expected revenues into the before and after rates analysis in the Test Year. USPS-T-35, WP 1 at 14-15.

In the event, actual FY1999 data shows that nowhere near 25% of residual shape volume were not surchargeable. The witness conceded that the

estimates on which its revenue calculations are based understate the revenues that the Postal Service actually derived (at the 10-cent surcharge) by \$17.8 or \$24.6 million.³ Tr. 48/22488.

The Postal Service's claim that actual FY1999 data should have no effect on the proper level of the surcharge for the Standard (A) Regular commercial subclass cannot be credited. Plainly, the Commission cannot simply allow the Postal Service to pocket this money. Nor is it appropriate for the Commission to apply these found revenues against base rates for Standard (A) Regular mail: the revenues are directly derivable from pieces that are subject to the surcharge. They should, therefore, be taken into account in determining the appropriate level of the surcharge. Because the Postal Service has not, and refuses, to reflect these found revenues in its proposed surcharge, it has definitionally overstated the proper level of the surcharge applicable to the Standard (A) Regular commercial subclass.

2. The Mismatch Between the Measurement of Parcel Costs and the Measurement of Revenues Virtually Precludes a Measurement of the Cost Differential Between Parcels and Flats. Although witness Moeller at least made some attempt to measure the volume of pieces that are surchargeable in developing his revenue estimates, witness Crum, who supplied the costing analysis -- upon which witness Moeller's testimony purports to be based -- freely conceded that his cost estimate simply ignored pieces that are flat-shaped and

³ The difference between these two calculations turns upon whether the hybrid year percentage of non-letters paying the surcharge or the percentage of non-letters paying the surcharge in that portion of FY1999 during the surcharge was in effect used. For purposes of this argument, the difference is not material.

are not prepared as parcels. Despite the fact that, by the terms of the DMCS itself, these pieces are not surchargeable they were nonetheless treated as parcels for purposes of the surcharge costing analysis:

"Probably the best way to answer that is that there has been -- there never has been -- a change in the costing systems over what is considered a parcel. Anything exceeding .75 inches is a parcel . . .

Q: Regardless of how it is prepared?

A: Regardless of how it is prepared . . .

Q: And that was true in FY1999?

A: Yes.

Tr. 8/3518; *see also*, Tr. 8/3433. Indeed, the witness stated explicitly that

"If I were to use 1999 data, the existing regulations for the flat automation rate could cause uncertainty in my present cost study methodology for the .75 inch to 1.25 inch thick qualifying pieces regarding what is a parcel and what is a flat.

Tr. 8/3433. In short, the definition of surchargeable pieces for volume and revenue estimation purposes exclude pieces that meet the definition of a flat (are less than 1.25 inches thick) and are prepared as flats. However, for costing purposes, the DMCS provision (which plainly holds that these pieces should not be surchargeable) is ignored and these pieces are treated as if they were subject to the surcharge.

It is very difficult to know what to make of this mismatch between revenue and cost estimations. It is certainly clear that the Postal Service's cost collection

methodology invalidates a central premise upon which the Commission recommended the surcharge in the first place. Relying on the Postal Service's representations, the Commission stated that

pieces prepared as parcels will be handled as parcels, with the associated cost of parcels, not the cost of letters or flats similarly, the IOCS definitions of shape are clear for costing purposes.

Decision in Docket R97-1 at 424, ¶5481. It turns out that this equation is only half true: Pieces prepared as parcels are being handled as and costed as parcels; but pieces that meet the definition of a flat and are prepared as flats are also being treated as parcels "for costing purposes." And, as witness Crum himself forthrightly stated there is simply no way to know what effect this mismatch between the operation of the DMCS and the Postal Service's costing methodology has on the measurement of cost differentials. This should compel the Commission to be very chary before recommending a 180% increase in the residual shape surcharge for the Standard (A) Regular commercial subclass.

D. The Surcharge for Standard (A) Regular Commercial Mail Should Not Exceed 13-Cents Before the Barcode Discount

While there is no question that the proposed 18-cent (before pre-barcode discount) surcharge proposed by the Postal Service must be rejected in application to the Standard (A) commercial subclass, it will be considerably more difficult for the Commission to try to determine, with appropriate analytic rigor, precisely at what level the surcharge for the Standard (A) commercial class should be set. Given the collapse of the Postal Service's cost measurement

systems in application to surchargeable pieces, it can be argued, with some conviction, that the surcharge for this subclass should be retained at the current 10-cent rate and that the 3-cent per piece barcode discount should be applicable to that surcharge. At the upper boundary, and even if the Commission wrongly insists upon a uniform surcharge across all subclasses, the surcharge (before barcode discount) should not exceed that proposed for the two ECR subclasses, 15 cents. It is not uncommon, and probable permissible as a legal matter, for the Commission to roughly split the difference between the upper and lower ends of the range. This yields a surcharge of 13 cents against which the pre-barcode discount would apply. Certainly, given the methodological and factual errors the Postal Service has committed, it cannot be heard to complain that a 13-cent surcharge before barcode discount is unreasonable. Nor would such a surcharge unfairly or improperly burden other rate categories in the Standard (A) Regular commercial subclass -- rate categories that are, in fact, used by RIAA members themselves.

II. The Infirmities In The FY1999 Data Concerning The Costs of Special Standard (B) Mail Must Be Rectified

A. There is No Dispute that the 1999 Costs of Special Standard (B) Are Wrong

When the Postal Service first filed its FY1999 CRA and billing determinant data, those data reflected very substantial increases in the costs, and particularly the mail processing-related costs, of Special Standard (B) mail. The Commission inquired into the Postal Service's understanding of this phenomena. The response was not illuminating:

CHAIRMAN GLEIMAN: The unit costs for Standard (B) Special mail increased between FY '98 and FY '99 by 21 percent from \$1.30 to \$1.56. Much of this increase, 17 cents, appears to be related to Cost Segment 3, clerks and mail handlers.

Can you explain why the Cost Segment 3 costs have increased so much?

THE WITNESS [MR. PATELUNAS]: I haven't looked at that. I don't know.

CHAIRMAN GLEIMAN: Okay, so then you wouldn't be able to tell whether there had been a change in mail characteristics or processing procedures?

THE WITNESS: I don't know.

Tr. 35/16833. The Postal Service subsequently (on August, 7) provided the following institutional responses to these two questions:

There were methodological changes between fiscal year 1998 and fiscal year 1999. However, even using comparable methodologies for 1998 and 1999, Special Standard mail processing costs still increased (46.3% under the PRC version between base year 1998 and fiscal year 1999, 43.6% under the USPS version). The increase is due primarily to an increase in Special Standard direct tallies. A change in the endorsement requirements for Special Standard in fiscal year 1999 may have resulted in improved identification and contributed to an increase in IOCS special Standard observations. In addition, Special Standard observations could vary due to sampling error or underlying cost changes

We are not aware of any changes in mail characteristics or processing procedures that would have contributed to the increase in Special Standard unit costs, other than the endorsement change implemented in January 1999, mentioned in the previous response. (The change was that the special

Standard Rate marking had to be in the postage area rather than just anywhere on the piece.)

Response of United States Postal Service to questions raised at hearing on August 3, 2000. Tr. 46-C/21048, 21047.

Stuart W. Elliott, testifying for RIAA, sought to analyze the underlying BY1998/FY1999 cost data and evaluate the Postal Service's substantially hypothetical explanations of those data. Dr. Elliott performed a statistical analysis and found that:

Using this coefficient of variation, it is possible to derive a 95% confidence interval for mail processing costs for Special Standard that ranges from a low of \$71,150,000 to a high of \$90,582,000.

Tr. 41/18031 (footnote omitted). Because the FY1999 data are substantially above the high point of this range, Dr. Elliott concluded that, "the discrepancy between the BY1998 and FY 1999 costs is too large to be caused by sampling variations alone." *Id.* He then proceeded to test what he conceived of as the only two possible explanations for the variation in the numbers: "that there is either something wrong with the figures for one of the two years or that there was a significant cost change between the two years." *Id.* He concluded, "that the former is the case and that the problem appears to lie with the FY1999 costs estimates." Tr. 41/18032.

There was one more step to the testimonial dialogue concerning BY '98/FY '99 variation in mail processing costs for Standard (B) mail. As directed by the PRC, the Postal Service presented a witness to advance its best

understanding of what had caused the dramatic change. Mr. Degen tacitly agreed with Dr. Elliott that the difference in reported costs were not, in major part, due to actual changes in costs. He offered the following substitute explanation:

However, a portion of the anomalous cost increase was most likely due to some Standard (A) Regular tallies being recorded as Special Standard, which may have resulted from the change in marking for Standard (A) mail from "Bulk Rate" to "Presort Standard."

B. Mr. Degen's Proffered Explanation For The Cost Variance Phenomenon Is Not Persuasive

The lynchpin of Mr. Degen's explanation for the belief that the change in Standard (A) endorsement contributed substantially to the confusion in tallies is that, though the change would not become mandatory until January of 2001, "... it became optional July 14, 1998 and was widely publicized as part of the January 10, 1999 rate implementation." Tr. 45/20052. As a demonstration of this wide publication, without which his explanation would make no sense, he cited to "Special Postal Bulletin 21984A, 11-12-98, page 13." *Id.* As Mr. Degen demonstrated while on the stand (Tr. 45/20063-65) the wide publication consisted of approximately six lines of relatively small print within a 170-page special edition of the Postal Bulletin.

Not only is the "widely publicized" predicate for Mr. Degen's theory questionable, but the internal logic of his supposition is suspect. As Dr. Elliott pointed out, "... the change in the endorsement requirements is unpersuasive as an explanation because it is not consistent with the stability of Special

Standard volume estimates." Tr. 41/18034. Dr. Elliott shows (Tr. 41/18030) that Special Standard volume increased by a bit less than five percent between BY '98 and FY '99 yet the mechanism for reporting Postal Service costs ("In-Office Cost System") is substantially identical to the procedure for estimating the volume of Special Standard mail (Domestic Revenue Pieces and Weight System). As Dr. Elliott points out, logic would dictate that if a labeling change led misestimations of costs in the IOC System, it should have led to comparable misestimations of volume in the DRPW System. It did not.

C. The "Remedy" That Flows From Mr. Degen's Theory of Cause Is As Infirm As That Theory; Dr. Elliott's Proposal Is Much More Sound

Mr. Degen reasons from his theory of misidentification that the appropriate cure to the variance problem is to drop from the IOCS cost count those tallies that have internal evidence of mistaking Standard (A) for Special Standard (B) pieces. Precisely because his theory of misidentification is infirm, so is the relief that he proposes.

Dr. Elliott takes a different approach. He concludes that:

If the Commission decides to base its recommended rates on FY '99 update figures, the BY '98 mail processing cost figures should be used instead to derive an alternate FY '99 estimate for Special Standard.

Tr. 41/18037. He also provides a mechanism for doing this. *Id.* That results in Special Standard costs of \$86,575,000.00 or \$0.432 per piece. *Id.* Dr. Elliott's

approach is by far the more sound of the alternatives before the Commission and it should be adopted.

CONCLUSION

The residual shape surcharge for the Standard (A) Regular commercial subclass should be set at not more than 13 cents, before the proposed barcode discount. In developing the rates for Special Standard (B), the Commission should make the cost adjustment proposed by RIAA.

Respectfully submitted,


A handwritten signature in black ink, appearing to read "D. Volner", with a stylized flourish to the left.

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the rules of practice.



Ian D. Volner